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No. 89-393

Supreme Court, U.S.

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In the Supreme Court of the United States

OCTOBER TERM, 1989

HARRY P. BEGIER, JR., ETC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether a debtor's pre-petition payment of its trust fund tax obligations can be avoided as a preference under Section 547 of the Bankruptcy Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A2-A20) is reported at 878 F.2d 762. The oral opinion of the district court (Pet. App. A22-A26) is unreported. The opinion of the bankruptcy court (Pet. App. A27-A44) is reported at 83 Bankr. 324.

JURISDICTION

The judgment of the court of appeals was entered on June 30, 1989. A petition for rehearing was denied on July 28, 1989 (Pet. App. A1). The petition for a writ of certiorari was filed on September 11, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This case involves payments of trust fund taxes made to the government by a corporate debtor during the 90-day period before the debtor petitioned for relief in bankruptcy. Section 547 of the Bankruptcy Code (11 U.S.C.) allows the bankruptcy trustee to recover as a preference certain payments made out of the property of the debtor during this 90-day period. Trust fund taxes are those

taxes, such as transportation excise taxes and employees' federal income and social security taxes, that third parties are required to withhold or collect from others on behalf of the United States. See 26 U.S.C. 3102, 3402 and 4291. The Internal Revenue Code provides that these amounts collected by third parties are to be "held * * * in trust" for the United States and later paid over to the government. 26 U.S.C. 7501.

1. Petitioner is the trustee in bankruptcy of American International Airways, Inc., a commercial airline that formerly provided passenger and air cargo service in the eastern and midwestern United States (see Pet. 4). By the spring of 1984, American International had become delinquent in remitting to the United States the social security and income taxes that it had withheld from the wages of its employees, as well as the excise taxes that it had collected from its passengers. On March 1, 1984, the Internal Revenue Service (IRS) notified the company of its delinquency and required it thereafter to file monthly rather than quarterly returns of its employment and excise taxes. The IRS also required American International to establish a separate bank account for the deposit of these trust fund taxes collected from employees and passengers. Pet. App. A4, A29-A30.

Shortly after receiving this notification, American International opened a separate bank account into which it deposited *some*, but not all, of the excise and employment taxes that it held in trust for the government. On April 30, 1984, American International paid the IRS \$695,000 from its separate trust account and \$734,798 from one of its general operating accounts. The April payments were followed by two other payments from that general account in June, totalling \$211,636. By agreement with the IRS, the company allocated the June 27 payment of \$11,636 to its 1982 and 1983 excise taxes and allocated the other payments to specific withheld social security, income, and excise taxes due between January and April, 1984. Pet. App. A4, A30-A31, A47-A48.

On July 24, 1984, American International filed a petition for relief under Chapter 11 of the Bankruptcy Code and attempted to operate as a debtor-in-possession for the next three months. After this attempt proved futile, the bankruptcy court appointed petitioner as the company's trustee and began liquidation proceedings. Following his appointment, petitioner commenced an adversary proceeding to recover the \$1,641,434 in withholding and excise taxes that the company had paid to the IRS in April and June 1984. Petitioner contended that these funds were recoverable as a voidable preference under Section 547 of the Bankruptcy Code because they were transferred to a creditor less than 90 days before the bankruptcy petition was filed. Pet. App. A4, A27-A28.

2. The bankruptcy court permitted the trustee to recover a portion of the funds in question (Pet. App. A27-A44). It held that the \$695,000 payment made by the company from its trust account was a nonavoidable transfer of funds held in trust for the government, and therefore it did not allow the trustee to recover those funds (*id.* at A32). The court refused, however, to view the payment of the trust fund taxes made from the general account as a transfer of funds held in trust for the government, and therefore it allowed the trustee to recover most of the payments made from that general account (*id.* at A32-A44).¹ Relying on its analysis of the issue in a previous adversary proceeding in this case, the court concluded that funds could be excepted from characterization as preferential transfers on the ground that they were being held by the debtor in trust for the government "only where a tax trust fund is actually established by the debtor and the taxing authority is able to trace funds segregated by the debtor in a trust account estab-

¹ The court held that \$246,024 of the amount paid out of the general account was not a voidable preference because it was paid for taxes due less than 45 days before the payment and therefore constituted a payment in the "ordinary course of business" that is not voidable. Pet. App. A43-A44. See 11 U.S.C. 547(c)(2).

lished for the purpose of paying the taxes in question" (*id.* at A35).²

The government appealed the bankruptcy court's holding that a debtor's payment of its trust fund obligations could be considered the payment of funds held in trust for the government only if the payment came from a segregated account. The district court affirmed in a decision issued from the bench (Pet. App. A22-A26). The court stated that this is "a very close case" (*id.* at A26), but concluded that the bankruptcy court correctly held that the payments from the general account should not be treated as having been made out of a trust fund. While the court expressed doubt that the bankruptcy court had required "as strict a tracing as what the IRS apparently" believed, the district court concluded that the IRS must show "some evidence beyond that of merely having made the payment" in order to establish that payments from commingled funds were actually payments of funds held in trust (*id.* at A25).

3. A divided court of appeals reversed (Pet. App. A2-A20). After reviewing the legislative history of Section 547, the court concluded that Congress regarded "the act of payment of withholding taxes [as] identif[y]ing those taxes as funds held in trust" (Pet. App. A16). The court drew a distinction between preference actions brought by a bankruptcy trustee to recover pre-bankruptcy payments—the context of this case—and efforts by the IRS to recover trust funds from the bankruptcy estate. The court noted that, in the latter context, Congress sought to relax the strict tracing required by lower court interpretations of this Court's decision in *United States v. Randall*, 401 U.S. 513 (1971), and established the rule that the IRS

² In the prior proceeding, the bankruptcy court had authorized the trustee to surrender funds remaining in the special trust account to the IRS. In so doing, the court had stated that a creditor successfully claiming specific funds is "obliged to make a strong showing of not only the creation of a trust, but also the tracing of the specific funds against which a trust is allegedly imposed in the possession of the debtor and/or trustee." *In re American International Airways, Inc.*, 70 Bankr. 102, 105 (Bankr. E.D. Pa. 1987).

can use "reasonable assumptions" to trace funds in the bankruptcy estate to withheld taxes (Pet. App. A10-A11). When the debtor pays the taxes before bankruptcy, however, the court ruled that the taxing authority need not rely on reasonable assumptions to trace the payments back to the funds withheld by the employer. Rather, the court held that the legislative history demonstrates Congress's intent that monies paid by the debtor for withholding taxes should be regarded as the payment of trust funds and therefore not a preference (*id.* at A13-A19). The court concluded that Congress provided that "the debtor's pre-petition payments on account of its tax withholding obligations are held to be a special fund in trust for the IRS for the government under I.R.C. § 7501 and are not preferential transfers of the debtor's property under 11 U.S.C. § 547(b)" (*id.* at A20).

The court of appeals acknowledged that its holding conflicts with *Drabkin v. District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987), which it characterized as "squarely address[ing]" the same question presented here. The court stated that it found "the *Drabkin* dissent convincing" (Pet. App. A13), explaining that the majority in *Drabkin* had misinterpreted the legislative history of Section 547 and had failed to distinguish between a debtor's pre-petition payment of withheld taxes and a post-petition action by the IRS to recover withheld taxes in possession of the estate (see Pet. App. A18-A19). Judge Hutchinson dissented for the reasons set forth by the majority in *Drabkin* (*id.* at A20).

DISCUSSION

The decision below correctly holds that the pre-petition payments of trust fund taxes made by the debtor in this case were not transfers of "property of the debtor" and hence are not subject to recovery as a preference under Section 547 of the Bankruptcy Code. We agree with petitioner, however, that the decision below conflicts with *Drabkin v. District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987). Because this conflict involves a recurring issue of considerable importance to bankruptcy administra-

tion, we do not oppose the granting of certiorari in this case.

1. Section 7501 of the Internal Revenue Code (26 U.S.C.) provides that certain taxes are to be collected by third parties and "held to be a special fund in trust for the United States" until they are paid over to the government. Section 547 of the Bankruptcy Code (11 U.S.C.), as applicable to this case, allows a trustee to avoid as a preference certain transfers "of property of the debtor" made within 90 days before the debtor files a petition in bankruptcy.³ The Bankruptcy Code does not explicitly define the phrase "property of the debtor," and therefore its terms alone do not conclusively establish whether amounts paid to satisfy the debtor's trust fund tax liability should be regarded as "property of the debtor," notwithstanding the command of 26 U.S.C. 7501 that such funds are held in trust for the government. Nothing in the statute, however, supports the bankruptcy court's conclusion here (see Pet. App. A35) that such payments will not be viewed as having been made out of the trust fund unless the funds have been segregated in a special account established for the purpose of keeping the withheld taxes.

To the contrary, the legislative history of Section 547 clearly demonstrates that Congress intended that pre-petition payments of trust fund tax liabilities would not be voidable as a preference even if they were made out of non-segregated funds, as in this case. The House Report states (H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1978)):

A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code § 7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing au-

³ Section 547 was amended in 1984, but the amendments do not bear on the issue presented here. The 1984 amendments, however, did change the phrase in question from "property of the debtor" to "an interest of the debtor in property." Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, Tit. III, § 462(b) (1), 98 Stat. 378.

thority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments.

As Judge Ruth Ginsburg stated in her dissent in *Drabkin v. District of Columbia*, 824 F.2d at 1118, this passage clearly manifests the view that, "if the debtor is able to make the payment, the taxes 'have been properly held for payment,' which places the trust beneficiary in a class separate from other creditors and thus removes this payment from the category of preferences voidable by the trustee." See also *Razorback Ready-Mix Concrete Co. v. United States*, 45 Bankr. 917, 922 (Bankr. E.D. Ark. 1984); *Pereira v. United States (In re Rodriguez)*, 50 Bankr. 576, 580-581 (Bankr. E.D.N.Y. 1985). As the court below recognized (Pet. App. A18), this rule that pre-petition payments of trust fund taxes are not a preference "reflects a proper consideration of the distinct nature of withholding taxes."

Moreover, even in situations where the amounts in question have not been denominated by the debtor as payments of trust fund taxes, Congress has indicated that segregation in a special account is not necessary for identifying particular funds as being held in trust for the government. Section 541(d) of the Bankruptcy Code excludes from the definition of "property of the estate" that property in which the debtor holds "only legal title and not an equitable interest." Thus, property held by the debtor in trust does not become part of the bankruptcy estate, and it may be procured by the equitable owner even after the bankruptcy petition has been filed. This principle is fully applicable to withheld taxes being held in trust for the government. See 124 Cong. Rec. 32417 (1978) (statement of Rep. Edwards).

Prior to the enactment of the Bankruptcy Code in 1978, the courts generally had imposed upon the IRS a very strict burden to trace withheld taxes into the debtor's general funds in order to claim that certain amounts should be excluded from the bankruptcy estate as funds held in trust for the United States. See, e.g., *In re Ken-*

nedy & Cohen, Inc., 612 F.2d 963 (5th Cir.), cert. denied, 449 U.S. 833 (1980); *In re Shakesteers Coffee Shops*, 546 F.2d 821 (9th Cir. 1976). This strict tracing requirement was derived from this Court's decision in *United States v. Randall*, 401 U.S. 513 (1971), which had held that, in the case of commingled funds, the priority provisions of the Bankruptcy Act overrode the trust created by 26 U.S.C. 7501. See 401 U.S. at 517; see generally 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards). In 1978, cognizant of the practicalities of withholding tax collection, Congress concluded that "a serious problem exists where 'trust fund taxes' withheld from others are held to be property of the estate where the withheld amounts are commingled with other assets of the debtor" (*ibid.*; *id.* at 34,017 (1978) (statement of Sen. DeConcini)). Accordingly, it determined to relax the strict tracing rule derived from *Randall* (*ibid.*):

The courts should permit the use of reasonable assumptions under which the Internal Revenue Service, and other tax authorities, can demonstrate that amounts of withheld taxes are still in the possession of the debtor at the commencement of the case. For example, where the debtor had commingled that amount of withheld taxes in his general checking account it might be reasonable to assume that any remaining amounts in that account on the commencement of the case are the withheld taxes.

Thus, even when trust fund taxes have not been paid over to the government, Congress contemplated that commingled funds could be identified as trust funds that can be obtained by the government because they should not be included in the property of the estate. It follows, *a fortiori*, that, where funds are actually paid to the IRS, prior to bankruptcy, to satisfy trust fund tax liabilities, payment from a special segregated tax account is not a prerequisite to preventing the bankruptcy estate from recovering those payments on the theory that the funds were not trust funds but rather were the property of the debtor. Thus, the court of appeals below correctly held that payments of outstanding trust fund tax liabilities

are not preferences that may be recovered by the bankruptcy trustee under Section 547.

2. We agree with petitioner that the decision below cannot be reconciled with *Drabkin v. District of Columbia, supra*. In that case, the trustee in bankruptcy sought to recover as a preference payments of withheld income taxes that had been made to the District of Columbia within the 90-day period prior to bankruptcy.⁴ A divided court of appeals affirmed the district court's order holding the payment to be a voidable preference. The *Drabkin* majority dismissed as "inapposite" (824 F.2d at 1113) the explicit statement in the House Report that pre-petition trust fund payments are not avoidable, which was heavily relied upon by the court below (see Pet. App. A13-A14), stating that it was addressed to the "on account of an antecedent debt" requirement of Section 547 (b) (2) and referred only to withholding tax payments made before the tax is due (824 F.2d at 1113; *id.* at 1117 n.41). The court then concluded that the "mere fact of pre-petition payment" earmarked to satisfy a trust fund obligation is not sufficient to identify funds as being held in trust for the government and therefore to prevent the transfer from being avoided under Section 547. 824 F.2d at 1116-1117. See also *In re R & T Roofing Structures & Commercial Framing Inc.*, No. 87-2985 (9th Cir. Oct. 23, 1989) (relying on *Drabkin* in a case involving IRS seizure during 90-day period).

The decision below directly conflicts with *Drabkin*. The court below acknowledged that *Drabkin* had "squarely addressed" the question presented here (Pet. App. A12),

⁴ Thus, the trust relied upon by the D.C. government in *Drabkin* was not imposed by 26 U.S.C. 7501, but rather by D.C. Code Ann. § 47-1812.8(f)(1) (1980). The court of appeals in *Drabkin* ascribed no significance to this fact, noting that the federal statute "essentially mirrors" the D.C. statute. 824 F.2d at 1105; see also *id.* at 1117 n.1 (Ruth Ginsburg, J., dissenting). The D.C. Circuit discussed in detail the legislative history that focused on Section 7501, and its opinion leaves no doubt that it would have reached the same result had the case involved the United States as tax collector, rather than the District of Columbia.

but found "the *Drabkin* dissent convincing" (*id.* at A13) and reached the opposite result. The court below discussed the reasoning of the *Drabkin* majority in great detail, and rejected it. The court specifically noted its disagreement with the *Drabkin* majority's dismissal of the House Report (see *id.* at A15 n.11), with its failure to recognize the relevant legislative history's specific focus on withholding taxes, as opposed to other tax liabilities (see *id.* at A18), and with its failure to "distinguish between pre-petition payment of withheld taxes and a post-petition action by the IRS to recover withheld taxes in the possession of the estate" (*ibid.*). In short, the court below agreed that the *Drabkin* majority's legal analysis was fully applicable to the facts here, it considered that analysis in great detail, and it concluded that the *Drabkin* majority had erred.

There is thus no doubt that a bankruptcy trustee's efforts to recover pre-petition payments of trust fund tax liabilities under Section 547 will yield different results on the same facts in the Third Circuit and the D.C. Circuit. Because of the administrative importance of this issue, resolution of this conflict in the circuits is warranted. Many thousands of business bankruptcies are filed each year, and bankrupt businesses typically have outstanding trust fund tax liabilities. Undoubtedly, a large number of these cases will involve payments of trust fund taxes within the 90 days prior to filing for bankruptcy, which would present the opportunity for an action by the trustee raising the question presented here. Indeed, there has already been considerable litigation in the bankruptcy courts on this issue (see Pet. App. A12), and the volume of that litigation may well increase in light of the recently emerged conflict. Depending upon the size of the business, these cases may involve considerable sums of money; in this case alone, the debtor made a total of more than \$1.6 million in trust fund tax payments within the 90-day period (although some of those payments came from a segregated account). Because of the importance of resolving this conflict in the circuits, we do not oppose the granting of certiorari.

CONCLUSION

The petition for a writ of certiorari should be granted.
Respectfully submitted.

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